

## I. INTRODUCTION

Contingent liabilities may be described as potential claims on bank assets for which any actual or direct liability is contingent upon some future event or circumstance. For examination purposes, contingent liabilities are divided into two general categories. "Category I" contingent liabilities are those that will result in a concomitant increase in bank assets if the contingencies convert to actual liabilities. These contingencies usually result from off-balance sheet lending activities such as loan commitments and letters of credit. When a bank is required to fund a loan commitment or honor a draft drawn on a letter of credit, it generally acquires a loan for the amount of liability incurred. "Category II" contingent liabilities include those in which a claim on assets arises without an equivalent increase in assets. Common examples of this category are pending litigation in which the bank is defendant and contingent liabilities arising from trust operations.

Additional information on off-balance sheet lending activities is contained in a separate section of this Manual.

## II. EXAMINATION POLICIES

Examination interest is predicated upon an evaluation of the impact contingencies may have on a bank's condition. Contingent liabilities which are significant in amount and/or have a high probability of becoming direct liabilities must be considered when the bank's ratings are assigned. The amount of contingent liabilities and the extent to which they may be funded must be considered in the analysis of the liquidity component of the CAMEL rating system. Determination of the management component may appropriately include consideration of contingencies, particularly off-balance sheet lending practices. Contingent liabilities arising from off-balance sheet fee producing activities have increased in significance as a means of enhancing bank earnings. In rating a bank's earnings, the impact of this type of fee income on earnings should be analyzed with consideration given to the present amount, quality, and expected future level of such income.

The extent to which contingent liabilities may ultimately result in charges against capital

accounts is always part of the examination process and this analysis is important in the assessment of the capital rating. Examiners should consider the degree of off-balance sheet risk in their analysis of the bank's overall capital adequacy and the determination of compliance with Part 325 of the FDIC Rules and Regulations. Part 325 does not explicitly include off-balance sheet activities in the leverage capital calculations, but it does indicate that off-balance sheet risk is one of the factors that will be considered in determining whether a higher minimum amount of capital should be required for any particular bank.

The total dollar amount of all contingent liabilities is to be included in the memorandum section of the Capital Calculation schedule of the examination report. A distinction is made between Category I and Category II contingent liabilities in determining adjustments to be made to capital. The examination procedures for Category I contingent liabilities are described under the heading for Adversely Classified Contingent Liabilities while those for Category II contingencies are included under the heading for Potential and Estimated Losses in Contingent Liabilities.

## III. POTENTIAL AND ESTIMATED LOSSES IN CONTINGENT LIABILITIES

For examination purposes, Category I contingent liabilities are defined as those which will give rise to a concomitant increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and, if appropriate, listed for Special Mention or subjected to adverse classification. This examination treatment does not apply to Category II contingent liabilities where there will be no equivalent increase in assets if a contingency becomes a direct liability. Examination treatment of Category I contingencies is covered under the heading Adversely Classified Contingent Liabilities in the Off-Balance Sheet Lending Activities Section.

For examination purposes, Category II contingent liabilities are those which are not expected to result in an increase in assets should future developments convert the contingencies into actual liabilities. A bank's exposure normally

depends solely on the probability of the contingencies becoming direct liabilities. To reflect the degree of likelihood that a contingency may result in a charge to capital accounts, the terms "Potential Loss" and "Estimated Loss" are used. A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. Potential loss refers to contingent liabilities in which there is substantial and material risk of loss to the bank. An estimated loss from a loss contingency (for example, pending or threatened litigation) should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of the loss can be reasonably estimated. For further information, examiners should refer to FASB Statement No. 5, "Accounting for Contingencies."

The dollar amount of Category II contingent liabilities are included with Category I contingencies in the memorandum section of the Analysis of Capital schedule of the examination report. Any Potential Loss identified is also reflected in the memorandum section. Estimated Losses are reflected in this schedule as adjustments to capital in determining adjusted primary capital and adjusted total capital. Estimated Losses are not included in adjustments to assets.

#### IV. COMMON FORMS OF CONTINGENT LIABILITIES

It is impossible to enumerate all the types and characteristics of contingent liabilities encountered in bank examinations. Some of the more common ones are discussed below. In all cases, the examiner's fundamental objectives are to ascertain the likelihood that such contingencies may result in losses to the bank and assess the pending impact on its financial condition.

##### Litigation

*If the bank is defendant in a lawsuit and the examiner determines that circumstances warrant inclusion in the examination report, then a supplemental schedule should be created. Comments should address the essential points upon which the suit is based, the total*

*dollar amount of the plaintiff's claim, the basis of the bank's defense, the status of any negotiations toward a compromise settlement, and the opinion of the bank's management and/or counsel relative to the probability of a successful defense. In addition, corroboration of information and opinions provided by bank management regarding the more significant suits should be obtained from the bank's legal counsel. At the examiner's discretion, reference to suits which are small or otherwise of no consequence may be omitted from the examination report.*

Determination of Potential or Estimated Losses in connection with lawsuits is often extremely difficult. There may be occasions where damages sought are of such magnitude that, if the bank is unsuccessful in its defense, it could be rendered insolvent. In such instances, examiners should consult their Regional Office for guidance. All Potential and Estimated Losses must be substantiated by comments detailing the specific reasons leading to the conclusion.

##### Interest Rate Futures, Forward and Standby Contracts

Banks that engage in futures, forward and standby contracts should do so only in accordance with safe and sound banking practices. Generally, utilization of such instruments should be to reduce interest rate risk exposure rather than for speculative purposes. Contingent liabilities arising from the bank's involvement in futures, forward and standby contract activity should be carefully evaluated in light of the impact such activity may have upon the bank's capital accounts and overall financial condition. The Corporation has issued a Statement of Policy which addresses various prudential issues to be considered in conjunction with such contracts. A detailed analysis of the policy statement on futures, forward and standby contracts can be found in the Securities Section of this Manual.

##### Trust Activities

Contingent liabilities may develop within the trust department from actions or inactions on the part of the bank in its capacity as fiduciary. These contingencies may arise from failure to abide by governing instruments, court orders, generally accepted fiduciary standards, or controlling statutes and regulations. Deficiencies in administration by the trust department can lead to

lawsuits, surcharges, or other penalties which must be absorbed by the bank's capital accounts. Therefore, the dollar volume and degree of severity of such contingencies must be analyzed during the safety and soundness examination. For further information refer to the heading "Contingent Liabilities" in Section VIII of the Manual of Trust Examination Policies.

#### **Consigned Items and Other Nonledger Control Accounts**

Banks often provide a large number of customer services which normally do not result in transactions subject to entry on the general ledger. These customer services include safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, sale of United States Savings Bonds and collection of department services. It is the bank's responsibility to assure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Power insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance or other unforeseen occurrences. Failure to take these protective steps may lead to contingent liabilities. The following is a brief description of customer service activities involving consigned items.

**(1) Customer Safekeeping - (a) Safe Deposit Boxes** - The bank and customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes and assumes responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate it has employed "reasonably prudent" care, it could be held liable. Access should be granted only after verifying the lessee's signature at each visit. The bank generally cannot gain access to a customer's safe deposit box except as allowed under certain statutes and/or court orders. **(b) Safekeeping** - In addition to items held as collateral for loans, banks occasionally hold customers' valuables. Banks should attempt to discourage this practice by emphasizing the benefits of a safe deposit box, but when not possible or practical to do so, the same procedures employed in handling loan collateral must be followed. **(c) Custodial Accounts** - Banks may act as custodian for customers' investments such as stocks, bonds or gold. When serving as custodian, the bank has

only the duties of safekeeping the property involved and performing ministerial acts as directed by the principal. As a rule, no management or advisory duties are exercised. Before providing such services, the bank should seek advice of legal counsel concerning applicable State and Federal laws governing this type of relationship. In addition, use of signed agreements or contracts which clearly define duties and responsibilities of the bank and the functions it is to perform is a vitally important first step in limiting potential liability.

**(2) Collection Items** - The collection department generally acts as agent for others in receiving, collecting and liquidating items. In consideration for this service, a fee is generally received. An audit trail must be in place to substantiate proper handling of all items to reduce the bank's potential liability.

**(3) Consigned Items** - These typically include traveler's checks and United States Savings Bonds. Banks share a fee with the consignor of traveler's checks. Savings bond proceeds are retained until remitted to the Federal Reserve. A working supply is generally maintained at the selling station(s) and the reserve supply should be maintained under dual control in the bank's vault.

#### **Reserve Premium Accounts**

*The American Bankers Association (ABA) has sponsored the creation of the American Banks Professional and Fidelity Insurance Company Limited (ABPFIC). The ABPFIC is a mutual insurance company that reinsures a portion of Progressive Company's directors and officers liability and fidelity bond insurance programs which are available to banks that are members of the ABA. Banks that obtain insurance coverage from Progressive become members of ABPFIC. As a mutual reinsurance company, ABPFIC has established a mechanism by which its members are required to provide additional funds to ABPFIC to cover losses (including related costs that are incurred by the reinsurer as a result of its reinsurance activities if its own operating funds are insufficient).*

The mechanism is the "Reserve Premium Account" that each bank in the program must establish. The "Reserve Premium Account Agreement" between the bank and the ABPFIC provides for the bank "to deposit into the Account

an amount equal to the insurance premiums quoted by Progressive for the bank's first year combined Director and Officer Liability . . . insurance, Financial Institution Bond and such other coverages . . . written by Progressive." No funds are actually placed with or transferred to ABPFIC when a Reserve Premium Account is established. Rather, a bank can satisfy this "deposit" requirement by pledging or otherwise earmarking specific bank assets for this purpose. In this regard, the agreement neither identifies nor places restrictions on the types of assets that are acceptable for a Reserve Premium Account.

Unless ABPFIC makes a demand for payment from Reserve Premium Accounts to cover losses, the assets in such accounts remain the assets of the bank and any earnings on these assets "are the property of the Bank and need not be retained in the Account." Any demand for payment would reportedly be made on a pro rata basis to all banks that must maintain a Reserve Premium Account.

When a bank enters into a Reserve Premium Account Agreement with ABPFIC and establishes its Reserve Premium Account, a "Category II" contingent liability arises in an amount equal to the bank's "deposit" into this account.

Under Financial Accounting Standards Board (FASB) Statement No. 5, "Accounting for Contingencies," a bank would accrue an estimated loss from the contingent liability resulting from its having entered into a Reserve Premium Account Agreement with ABPFIC when and if available information indicates that (1) it is probable that ABPFIC will make a demand for payment from the account and (2) the amount of the payment can be reasonably estimated. Thus, when a bank established a Reserve Premium Account or increases the amount in its account, a simultaneous charge to expense (or to undivided profits) in an amount equal to the book value of the assets pledged or otherwise earmarked for the account would normally be inappropriate.

*The book value of the bank assets used to satisfy the Reserve Premium Account requirement should be shown in the proper balance sheet category and included as a pledged asset on an appropriate worksheet. This is true even in those instances where the assets earmarked for the account have not been formally pledged. The effect on a bank's liquidity of such a contractual earmarking is, in substance, the*

*same as if the assets had actually been pledged.*

*If a bank has pledged or otherwise earmarked any "short term and marketable assets" (e.g., securities) for its Reserve Premium Account, the amount of the bank's contingent liability should be reflected on the supplemental page 7, Liquidity Ratio and Dependency Ratio, as a reduction of short term and marketable assets. In other words, the amount of the contingent liability should be included as "liabilities secured by any of the above." The reasoning for this treatment is that even when the bank's Reserve Premium Account requirement is a contingent rather than an actual liability, assets used to satisfy this requirement are not available to meet the bank's liquidity needs.*